



RESPONSE TO THE FEDERAL HOUSING FINANCE AGENCY REQUEST FOR COMMENT ON HOW ITS REGULATIONS MAY BE MADE MORE EFFECTIVE AND LESS BURDENSOME

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I appreciate the chance to respond to the Federal Housing Finance Agency's (FHFA) request for comments on how its regulations may be made more effective and less burdensome. This comment relates to continuing efforts to maintain safe and sound access to credit for creditworthy borrowers, as referenced in the annual report to Congress.¹

This comment is submitted with the assistance of the Mercatus Center at George Mason University, which is dedicated to advancing knowledge about the effects of regulation on society. As part of its mission, the Mercatus Center conducts careful and independent analyses that employ contemporary economic scholarship to assess rulemaking proposals and their effects on the economic opportunities and the social well-being available to all members of American society.

This comment addresses the efficiency and efficacy of FHFA oversight of Fannie Mae and Freddie Mac (hereafter "Enterprises") from an economic point of view. The Enterprises have a long history of facilitating home ownership, and continued progress on this goal through a systemically safe framework is something that all Americans should be able to support. The rise and fall of housing markets before the financial crisis has been widely blamed on declining underwriting standards, so those standards have been tightened since the crisis. But lending standards in terms of borrower qualifications appear to have been commendably stable at the Enterprises before the crisis. Tightening standards since the crisis have shifted the Enterprises away from longstanding norms. Tight lending standards have been destabilizing because they have prevented home buyers from accessing the benefits of ownership, and they have undercut demand for homeownership in

¹ Federal Housing Finance Agency, *2016 Report to Congress*, June 15, 2017, 51-54.

regions where, for decades, buyers had reliably depended upon the services of the Enterprises. A return to longstanding norms will support continued recovery of lost home equity value for existing owners. Transitioning from renter to owner has rarely been more affordable. Both current owners and new buyers will benefit.

THE ROLE OF THE ENTERPRISES IN HOUSING AFFORDABILITY

Housing policy should pursue two separate and important objectives: (1) the affordability of housing and (2) access to the benefits of ownership. The first objective has mostly to do with the rental expense of households as tenants, and the second objective has more to do with prices and credit. Rental expenses are largely a reflection of supply and demand in a given location at a given time. Prices and credit reflect a more complicated set of factors in capital markets.

First and foremost, the affordability of housing rents is the more primary goal, because failure on this objective means that households can lack the means for shelter. Access to ownership is also important and provides ample benefits to individual households and to society at large, but the downside of being an owner versus being a tenant is much less problematic than the downside of being a tenant versus being homeless.

The Enterprises can have a positive effect on both rental affordability and homeownership, but it is also important to understand these motivations separately in order to craft policies that produce the highest public benefit.

The Enterprises have provided many creditworthy families with access to ownership by ensuring the soundness and liquidity of mortgage markets. This has granted the benefits of ownership to millions of American families, which is a valuable service in and of itself. But more importantly, access to ownership has been an important source of funding for new housing supply. This indirectly affects the first objective noted earlier—the affordability of housing. New supply helps to keep the rental value of homes in check.

Millions of households that would have been creditworthy owners in past decades are not owners today. The lack of access to credit for those potential buyers has reduced homeownership rates for working-age households to the lowest levels in more than 35 years.² The post-crisis bias toward prudence has suppressed new housing supply enough that it is now causing rents to rise. This is leading to a vicious cycle of unaffordability as a lack of supply leads to rising rent, which then makes it more difficult for potential new buyers to fund new supply, which leads to more rising rents, and so on.

A return to long-standing precrisis lending norms would be an important source of improved housing affordability.

² US Census Bureau, “Housing Vacancies and Homeownership (CPS/HVS): Table 15. Annual Estimates of the Housing Inventory by Age of Householder and Family Status: 1982 to Present,” accessed April 20, 2018, <https://www.census.gov/housing/hvs/data/histtabs.html>.

RISING HOME PRICES DURING THE HOUSING BUBBLE WERE ALSO PRIMARILY CAUSED BY A LACK OF SUPPLY AND RISING RENTS

During the housing boom that preceded the financial crisis, home prices in some cities rose to exceedingly high levels. Viewing housing affordability through the lens of home prices, this appeared to be a time when housing was becoming unaffordable for many Americans.

Furthermore, prices rose quickly in a short time frame. Those rising prices seemed to be related to loose credit markets or aggressive lending from the Enterprises and private lenders. The tightening of credit standards seemed like a reasonable response to the affordability problem, and the foreclosure crisis that followed appeared to confirm that loose lending had caused housing to become unsustainably unaffordable.

But a proper estimation of the role of the Enterprises during the housing bubble and after requires carefully viewing rental affordability separately from the affordability of homeownership.

The rising cost of housing during the housing boom was primarily a product of rising rents in places where local limits to housing expansion prevent local supply from expanding to meet rising demand. This is most acute in a handful of metropolitan areas that are centerpieces of the new economy and thus attract many newcomers in search of economic opportunity. Most notably, these areas include New York City, Los Angeles, Boston, and the San Francisco area.

In national data, rising prices didn't appear to be related to rising rents. But viewing metropolitan areas individually makes it clear that rising rents in this handful of metro areas were the primary source of rising prices. Those rising rents were even the source of the brief period of rising prices in places like Arizona, because much of the new housing in Arizona was being built to house the thousands of households that had to move away from California because of California's shortage of housing.³ The housing bubble was mainly caused by a localized housing shortage that caused rents in those locations to rise. Those rising rents led to a migration event that overwhelmed the housing markets in a few cities. Cities that had housing bubbles generally fall into two categories: (1) cities with housing shortages that led to endemic net out-migration that surged during the bubble, and (2) cities with generous local housing policies who experienced a disruptive surge of in-migration during the bubble. Local housing supply policies and migration flows explain the development of the housing bubble. Credit markets were facilitating activity that was caused by those other factors.

This is corroborated by the lack of evidence that standards related to borrower quality changed significantly during the boom. The Urban Institute tracks mortgage risks with their "Housing Credit Availability Index." According to their index, borrower risks were fairly stable during the boom. Risks in mortgage markets were generally the result of increasing risk in the terms of mortgages.⁴ Defaults early in the crisis were more a result of falling prices than a cause of them.⁵ The complex mortgages that led to many of the early defaults were taken out by sophisticated borrowers who had

³ Kevin Erdmann, "Housing Was Undersupplied during the Great Housing Bubble" (Mercatus Center Policy Brief, Mercatus Center at George Mason University, Arlington, VA, April 2018).

⁴ Urban Institute, "Housing Credit Availability Index," April 12, 2018, <https://www.urban.org/policy-centers/housing-finance-policy-center/projects/housing-credit-availability-index>.

⁵ Yulia S. Demyanyk, "Quick Exits of Subprime Mortgages," *Federal Reserve Bank of St. Louis Review* 91, no. 2 (March/April 2009): 79-93.

the means to make payments and tended to default more strategically in the face of falling prices.⁶ According to the American Community Survey, in 2006 and 2007 mortgaged homeownership declined first among households with incomes in the top quintile. Homeownership among households with lower incomes did not decline until 2008 and after, when they were confronted with the toxic combination of rising unemployment, collapsed home prices, and extremely tight lending standards.⁷

The rise of risky mortgages and the housing price surge of 2004–2006 were not associated with any rise in the rate of homeownership, generally.⁸ There was no rise in borrowing or ownership among households with lower incomes relative to households with higher incomes.⁹ And when homeownership had been increasing—from 1994 to 2004—the increase was almost entirely among young households with rising incomes and college educations.¹⁰ The Survey of Consumer Finances from the Federal Reserve also confirms that new homeownership throughout the housing boom was focused on households with incomes in the top quintiles, with college educations, and with managerial or professional jobs.¹¹ And the number of homes bought by first-time homebuyers was declining as early as 2005 and continued falling during the period after that (when so many mortgages led to foreclosures). The years when the bulk of bad mortgages were made were not years when the number of new homebuyers was swelling—quite the opposite is true.¹²

PUBLIC SOURCES OF MORTGAGE SUPPORT WERE COMMENDABLY COUNTERCYCLICAL DURING THE BOOM BUT HAVE BEEN PROCYCLICAL SINCE THE CRISIS

During that time, especially during the late price surge of 2004–2005, standards at the Enterprises were especially stable. One of the more striking trends during that period is their loss of market share during the boom years from 2003 to 2005. The combined market share of the Enterprises and the Federal Home Loan Banks, including mortgages held in portfolio or in pools sold to third parties, was about 37 percent at the end of 2003. It was down to 30 percent by the end of 2005.¹³ Federal Housing Administration lending programs pooled through Ginnie Mae were losing market share even more sharply and persistently. The combined market share of the Enterprises, the

⁶ Gene Amromin, Jennifer Huang, Clemens Sialm, and Edward Zhong, “Complex Mortgages” (NBER Working Paper No. 17315, National Bureau of Economic Research, Cambridge, MA, August 2011).

⁷ Author’s calculations based on data from the American Community Survey. See US Census Bureau, American Community Survey (ACS), accessed April 20, 2018, <https://www.census.gov/programs-surveys/acs/>.

⁸ US Census Bureau, “Housing Vacancies and Homeownership (CPS/HVS), Table 14a. Quarterly Seasonally Adjusted Homeownership Rates for the: 1980 to Present,” accessed April 20, 2018, <https://www.census.gov/housing/hvs/data/histtabs.html>; US Census Bureau, “Housing Vacancies and Homeownership (CPS/HVS), Table 17. Quarterly Homeownership Rates by Family Income: 1994 to Present,” accessed April 20, 2018, <https://www.census.gov/housing/hvs/data/histtabs.html>.

⁹ Board of Governors of the Federal Reserve System, “Survey of Consumer Finances, Table 9” and “Survey of Consumer Finances, Table 13” (referencing years from 1995 through 2016), accessed April 20, 2018, <https://www.federalreserve.gov/econres/scfindex.htm>.

¹⁰ Christopher L. Foote, Lara Loewenstein, and Paul S. Willen, “Cross-Sectional Patterns of Mortgage Debt during the Housing Boom: Evidence and Implications” (NBER Working Paper No. 22985, National Bureau of Economic Research, Cambridge, MA, July 6, 2016).

¹¹ Board of Governors of the Federal Reserve System, “Survey of Consumer Finances, Table 9.”

¹² Author’s calculations based on data from the American Housing Survey. See US Census Bureau, “American Housing Survey (AHS),” accessed April 20, 2018, <https://www.census.gov/programs-surveys/ahs.html>.

¹³ Board of Governors of the Federal Reserve System, “Mortgage Debt Outstanding,” March 8, 2018, <https://www.federalreserve.gov/data/mortoutstand/current.htm>. Market share is determined by summing lines 39, 45, 48, 57, and 60, and dividing the sum by line 1.

Federal Home Loan Banks, and Ginnie Mae mortgages declined from 40 percent in 1994 to 33 percent in 2005.¹⁴ The housing boom was not driven by aggressive public lending programs.

This stability is reflected in the book of business held by the Enterprises. Of all the mortgages with known FICO scores in Fannie Mae's book of business, in 2000, 63 percent had FICO scores below 740. As Fannie Mae's book grew in absolute terms during the boom, the portion of its book going to lower FICO scores gradually declined. It was 57 percent from 2005 to 2007. Then, in reaction to the crisis, credit standards were tightened drastically. In 2008, Fannie Mae's book of business included about \$1.2 trillion in mortgages associated with FICO scores above 740 and \$1.5 trillion in mortgages associated with FICO scores below 740. By 2015, only 39 percent of Fannie Mae's book of business had FICO scores at origination below 740; the book of business had increased to \$1.7 trillion for FICO scores above 740 and had decreased to \$1.1 trillion for FICO scores below 740.¹⁵ Freddie Mac appears to have followed a similar pattern.

MORE GENEROUS LENDING WILL IMPROVE HOUSING AFFORDABILITY

The period after 2008 is associated with sharp declines in housing starts and homeownership rates and worsening rent affordability. Reflecting on the difference between rent affordability and price affordability, it is clear that the Enterprises can play a role in both.

During the housing boom, new homes were mostly being constructed in less expensive areas. The noticeably high prices in the cities with housing shortages concealed one of the primary characteristics of the housing boom. The mass migration out of the expensive cities and the rise in housing starts at the time were part of a nationwide attempt at reducing housing costs. Even in places such as Arizona, where prices suddenly jumped in 2004 and 2005, the tens of thousands of additional residents who were moving into the state to claim those new homes were largely moving from California.¹⁶ They were moving into Phoenix to reduce their housing expenses. The same was true for the hundreds of thousands of other households who moved out of the high-priced cities and into the many other cities that avoided a bubble in home prices.

There are two distinct types of cities in the United States: (1) a handful of cities where local housing supply cannot match reasonable increases in demand, and (2) most other cities where supply can expand. In the first type of city, new avenues for mortgage access and home ownership mostly pushed up prices and created a migration event. In the second type of city, new avenues for home ownership fund new supply. The dominance of the cities with a shortage of housing during the housing boom has diverted the national consensus from that fact.

Where the Enterprises have had an active role in facilitating mortgage access, they have played an important part in both objectives for housing affordability. They facilitated the transition of

¹⁴ Board of Governors of the Federal Reserve System, "Mortgage Debt Outstanding," March 8, 2018, <https://www.federalreserve.gov/data/mortoutstand/current.htm>. Market share of Ginnie Mae mortgages is determined by the sum of lines 18, 21, 26, and 54, and dividing the sum by line 1.

¹⁵ Author's calculations based on Fannie Mae, "Annual Reports and Proxy Statements" Risk Characteristics of Conventional Single Family Business Volume and Mortgage Credit Book of Business), February 14, 2018, <http://www.fanniemae.com/portal/about-fm/investor-relations/annual-reports-proxy-statements.html>.

¹⁶ Author's calculations based on Internal Revenue Service, "SOI Tax Stats - Migration Data," November 30, 2017, <https://www.irs.gov/statistics/soi-tax-stats-migration-data>. The author thanks Michael Kelley for assistance in compiling IRS, ACS, and AHS data.

millions of households from tenants to owners. And indirectly but more importantly, they facilitated the development of new housing supply. In an age where a few important cities have housing shortages that have come to dominate the financial stresses of their residents, this factor is hugely important, even if the supply must be developed in Atlanta, Dallas, and Phoenix because such development is opposed in New York and California.

The Enterprises had little to do with rising prices in New York and California (private securitizations developed largely because market-clearing prices in those places frequently defy conventional lending standards). To the contrary, lending by the Enterprises was facilitating new supply in the parts of the country that permitted new supply. This provided an outlet of affordable housing for the millions of Americans forced to migrate from the cities where limited supply was causing rents and prices to be extremely high.

Because of the housing shortage, inflation rates on shelter had been higher than general core inflation for a decade from 1995 to 2005. It was only at the peak of homebuilding activity that shelter inflation briefly reconverged with general core inflation. Then, as soon as housing starts began to decline in 2006, shelter inflation shot up again. It continues to run high. In the 12 months leading up to March 2018, prices on shelter have risen 3.3 percent while prices on all items other than energy, food, and shelter have only risen 1.2 percent. This has been the pattern for much of the recovery.¹⁷

The Enterprises were a source of stability during the housing bubble, both because their book of mortgages performed well compared to other conduits for mortgages and because the federal backstop stabilized mortgage-backed securities markets. It has been their retreat from generous lending that has contributed to instability since then. Enterprise lending has shifted toward more valuable homes purchased by borrowers with higher FICO scores. But the housing bubble was the result of a supply shortage and a migration event, not a decline in borrower quality. This shift in standards has therefore been misdirected, and funding for housing in low-tier markets has been hampered as a result. This has hampered housing supply in most cities, which is the primary reason for rising rents.

A return to the lending standards that the Enterprises used successfully for many years during and before the housing bubble would be a tremendous move toward both objectives for housing affordability. Mortgage affordability has never compared more favorably to rent affordability.¹⁸ Millions of American households who are qualified and capable of being owners have been kept out of the housing market. There is much room for expanded lending. The second goal—the facilitation of home ownership—can safely be accomplished today.

But more importantly, a new commitment to broad homeownership will trigger the development of new supply and will address the first goal—affordable rents. Because of the lack of capital

¹⁷ Historical inflation data are available by using the Bureau of Labor Statistics data retrieval tools. See Bureau of Labor Statistics, “All Items Less Food, Shelter, and Energy in U.S. City Average,” accessed March 9, 2018, <https://data.bls.gov/timeseries/CUSR0000SA0L12E>; Bureau of Labor Statistics, “Shelter in U.S. City Average,” accessed March 9, 2018, <https://data.bls.gov/timeseries/CUSR0000SAH1>.

¹⁸ Zillow Research, “Mortgage Affordability, Rent Affordability, Price-to-Income Ratio,” accessed April 20, 2018, <https://www.zillow.com/research/data/>.

flowing into low-tier housing markets, homebuilders are having trouble funding new lots.¹⁹ The focus on tight lending standards and on enforcing affordability of home prices has led to a lack of new supply and worsening affordability of rents. The focus on prudence in the second goal has led to a failure of the first goal. And now rents are rising enough to cause a failure to meet both goals.

It is true, however, that in the cities that have severe housing shortages, new borrowers will mostly only push up prices. In those cities, it could well be the case that more generous lending will be destabilizing and disruptive because it will allow some home buyers to consume more of the limited stock of housing. So while the country is in great need of more generous mortgage lending generally, it may be prudent to retain tight lending standards in cities where rising demand will only raise prices. In those cities, there is a conflict between the two affordability objectives, so the proper balance is less clear. But in most of the country, the shift to more generous lending standards will lead to better access and better affordability for both owners and renters. This should be a priority.

Please see the attached paper, which is an introduction to new research on the importance of low supply and migration during the housing bubble.

ATTACHMENT

“Housing Was Undersupplied during the Great Housing Bubble” (Mercatus Policy Brief)

¹⁹ Paul Emrath, “Shortage of Lots Now Worse Than Ever,” *Eye On Housing*, May 23, 2016. What is reported as a lack of the supply of lots might be more accurately described as a lack of the quantity supplied, which would certainly rise if the price builders could pay increased.



Housing Was *Undersupplied* during the Great Housing Bubble

Kevin Erdmann

April 2018

The lack of a strong recovery since the 2007–08 financial crisis has been a central theme of many economic discussions over the past decade. We might normally expect an especially deep economic contraction to be followed by an especially strong recovery. Why was this recovery different? One of the more widely cited causes of the slow recovery has been a surplus of homes left over from the boom.

In his memoir, former Federal Reserve Chairman Ben Bernanke wrote, “Normally, a rapid rebound in home construction and related industries such as realty and home improvement helps fuel growth after a recession. Not this time. Builders would start construction on only about 600,000 private homes in 2011, compared with more than 2 million in 2005. To some extent, that drop represented the flip side of the pre-crisis boom. Too many houses had been built, and now the excess supply was being worked off.”¹

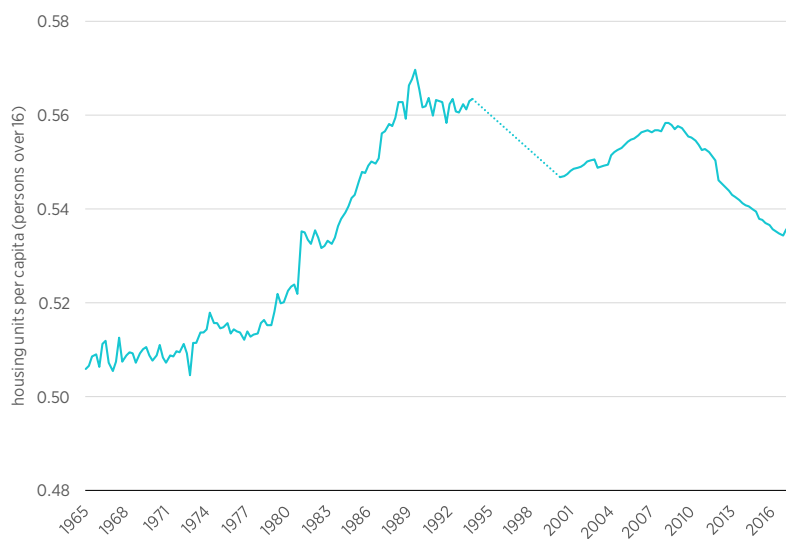
WHAT SUPPLY OVERHANG?

How bad was the supply overhang? Surprisingly, the answer may be that there never was one.

We can think about this in terms of stock (the number of homes in the United States) or flow (the rate at which new homes were being built).

In terms of stock, the Census Bureau maintains estimates of both US population and the number of housing units. As shown in figure 1, the ratio of homes to adults in the United States rose in the

Figure 1. Housing Units per Noninstitutional Population over Age 16



Note: There was a significant revision in the housing unit count after the 2000 Census, which causes a discontinuity in the measure. Also, the Census Bureau has produced a revised measure in table 8a (see source) for the years from 2000 to the present, so I have replaced the estimated counts from 1994 to 2000 with a linear trend (shown as a dotted line) connecting the previous decennial census revision to the earliest date with the new revised measure. The total rise in the ratio of units during the boom and the peak level of units in 2008 are similar in both the count from table 8 (see source) and the revised measure in table 8a. With either measure, the growth in housing units during the boom is mild, and the peak level of units remains below the estimates of the early 1990s.

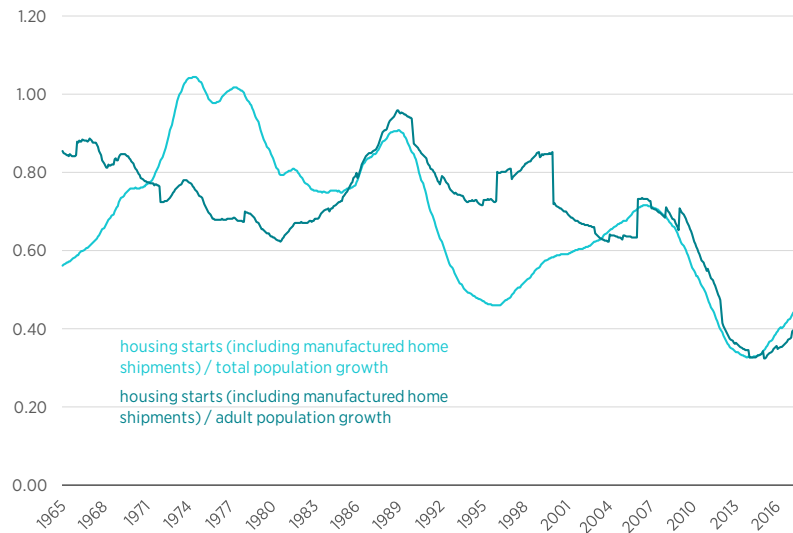
Source: US Census Bureau, "Housing Vacancies and Homeownership, Table 8. Quarterly Estimates of the Total Housing Inventory for the United States: 1965 to Present," accessed March 9, 2018, <https://www.census.gov/housing/hvs/data/histtabs.html>; US Census Bureau, "Housing Vacancies and Homeownership, Table 8a. Quarterly Estimates of the Housing Inventory," accessed March 9, 2018, <https://www.census.gov/housing/hvs/data/histtabs.html>; Federal Reserve Bank of St. Louis, "Civilian Noninstitutional Population," accessed March 9, 2018, <https://fred.stlouisfed.org/series/CNP16OV>.

1980s as a result of factors such as changing marriage norms. The ratio then declined in the 1990s. The relative number of housing units increased somewhat from 2000 to 2005 but remained below the previous peak level. After the crisis, the decline continued.

In terms of flow, the Census Bureau measures the construction of several forms of housing. Figure 2 shows the rolling five-year level of new housing starts (including manufactured homes, homes in multi-unit properties, and single-family homes) compared to total population growth (light blue line) and compared to adult population growth (dark blue line). The rate of housing starts was not unusual by either measure during the 2000–2010 period, and has since moved well below long-term norms.

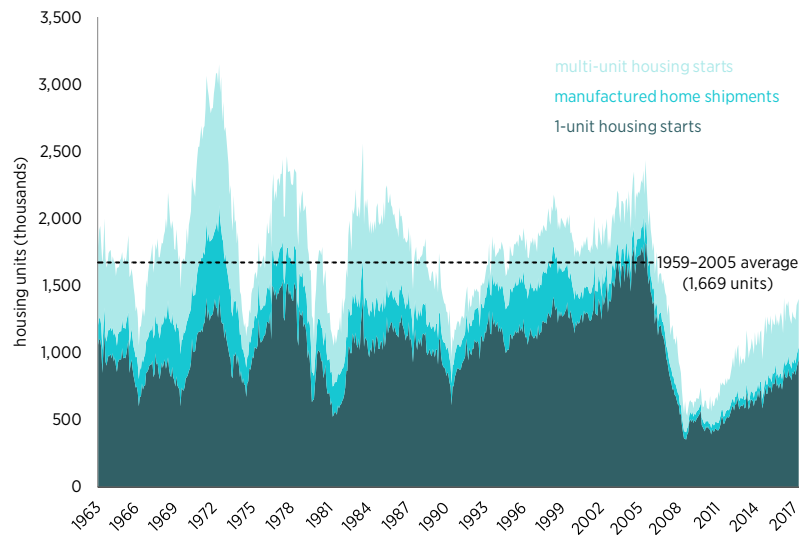
Figure 3 stacks the numbers of new housing units started or shipped over time. Single-family homes, at the bottom, make up the bulk of new housing units. Manufactured homes and multi-unit homes, which make up a relatively small portion of new housing units, stack on top. The horizontal dashed line shows the average number of new units built annually from 1959 to 2005—just before the crisis.

Figure 2. Housing Starts (Rolling Five-Year Level) Compared to Population Growth



Source: Federal Reserve Bank of St. Louis, “Civilian Noninstitutional Population,” accessed March 9, 2018, <https://fred.stlouisfed.org/series/CNP16OV>; Federal Reserve Bank of St. Louis, “Total Population: All Ages Including Armed Forces Overseas,” accessed March 9, 2018, <https://fred.stlouisfed.org/series/POP>; Federal Reserve Bank of St. Louis, “Housing Starts: Total: New Privately Owned Housing Units Started,” accessed March 9, 2018, <https://fred.stlouisfed.org/series/HOUST>; US Census Bureau, “Shipments of New Manufactured Homes,” accessed March 9, 2018, <https://www.census.gov/data/tables/time-series/econ/mhs/shipments.html>.

Figure 3. Housing Starts and Shipment, by Type



Source: Federal Reserve Bank of St. Louis, “Shipments of New Manufactured Homes”; Federal Reserve Bank of St. Louis, “Privately Owned Housing Starts: 1-Unit Structures,” accessed March 9, 2018, <https://fred.stlouisfed.org/series/HOUST1F>; Federal Reserve Bank of St. Louis, “Housing Starts: 2-4 Units,” accessed March 9, 2018, <https://fred.stlouisfed.org/series/HOUST2F>; Federal Reserve Bank of St. Louis, “Privately Owned Housing Starts: 5-Unit Structures or More,” accessed March 9, 2018, <https://fred.stlouisfed.org/series/HOUST5F>.

When including all types of units, this measure also suggests that nothing out of the ordinary was going on before the financial crisis. The number of housing units added during the boom was only slightly above the long-term average.

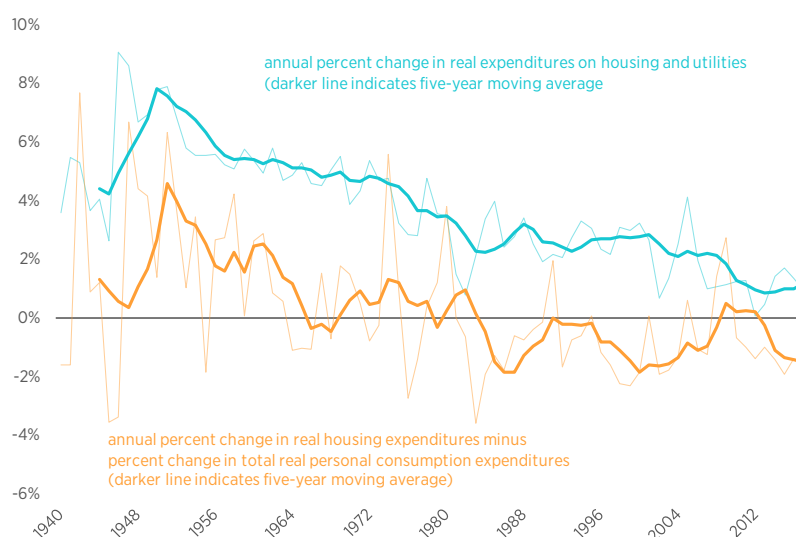
The Census data provide surprisingly little support for the claim that there were too many homes in 2005. Figure 3 provides a couple of hints about how policymakers came to believe that housing supply had been excessive and why, in fact, supply has actually been constrained. The number of single-family home starts, especially single-family homes built for sale, did rise to unprecedented levels. That is a high-profile category, where publicly traded homebuilders operate and where many families become new homeowners.

But the other categories were either stagnant or in decline over the long term. The growth in single-family homes built for sale came mostly by taking market share from the other types of units.

What caused this shift? The other categories face increasing regulatory hurdles: most notably, obstacles to housing expansion in several urban centers where many multi-unit properties would normally have been built.

Another way to measure the growth in the housing stock is to measure real expenditures on housing over time. Figure 4 shows the long-term annual growth in real housing expenditures (dark blue line). Housing consumption has been increasing more and more slowly over time. The dark orange line measures the growth in real housing expenditures minus the growth in total real spending.

Figure 4. Annual Percent Change in Real Housing Expenditures



Source: US Bureau of Economic Analysis, "National Data, Table 1.5.3. Real Gross Domestic Product, Expanded Detail, Quantity Indexes," accessed March 9, 2018, <https://www.bea.gov/iTable/iTable.cfm?reqid=19&step=2#reqid=19&step=2&isuri=1&1921=survey>. Data were retrieved using the "Housing and Utilities" category.

This raises the question, Was real consumption of housing growing more quickly than real consumption in general? As real income increases, is housing a larger portion of the new basket of goods and services or a smaller portion than it had been before?

Households have been increasing their consumption of housing more slowly than they have increased their consumption of other goods. The idea—frequently claimed—that there was a housing bubble in the 2000s that was the result of Americans “keeping up with the Joneses,” buying trophy houses or overinvesting in new homes in a misguided attempt at saving or speculating, is wrong. Americans have been doing the opposite.

That said, the portion of the average household’s budget going to housing each year has remained level. In 1984, housing comprised 18 percent of total personal consumption expenditures, and in 2017 it still comprised 18 percent.² American households have been spending a stable amount of their incomes on housing for decades, but they keep getting less and less house for it. Since 1995, the rate of inflation on shelter has averaged 0.75 percentage points higher, annually, than the rate of inflation on other consumption items.³ For the last few decades, when Americans’ incomes have risen, their homes have only improved slightly, but their rents have increased more. Americans have had to limit their consumption of housing in order to try to keep their housing expenses at a comfortable level. We have been engaged in the opposite of overbuilding.

THE CLOSED ACCESS PROBLEM

Just a few cities are at the heart of the housing supply problem, most notably New York City, Los Angeles, Boston, and San Francisco,⁴ which I refer to as Closed Access cities. There are two very different housing markets within the United States: the Closed Access market, where new housing is highly constrained, rents rise relentlessly, and households are forced to make difficult choices as housing expenses eat up their budgets; and the rest of the country, where homes can generally be built to meet demand, housing construction is healthy, and housing expenses remain at comfortable levels for the typical household.

If we add these two markets up into an aggregate market, it looks like a market where rents are relatively level over time. In the 2000s, when housing starts were rising and home prices were also rising to unusually high levels, it appeared as if those rising prices were unrelated to rent, and it appeared that prices were rising at the same time that supply was rising. This pattern, rising prices and quantities, seemed to be the result of excess demand—too much credit and too much money funding too much housing.

Yet few places fit that description. For the most part, there were places where housing starts were low, while rents and prices were both rising, and there were places where housing starts were healthy, while rent and price increases were moderate. If we compare median annual rent

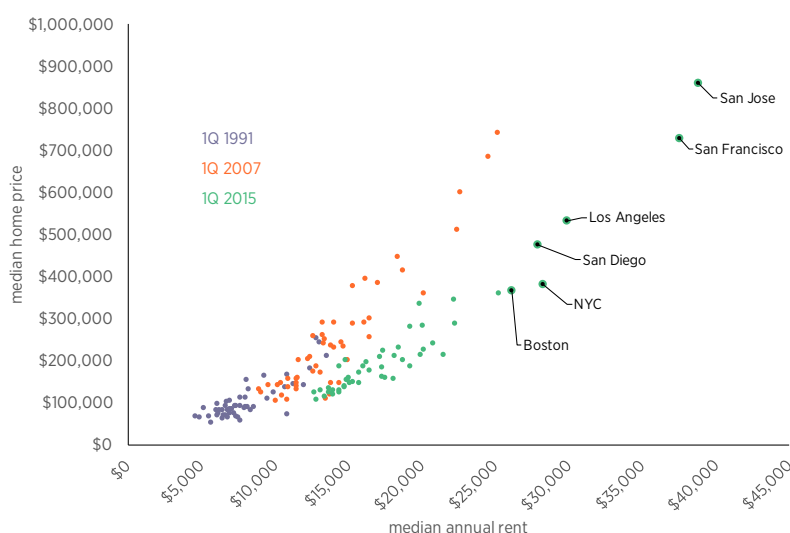
and median home price within each metropolitan area, it is clear that rents were an increasingly important determinant over the past two decades of home price differentials between different metropolitan areas. And as shown in figure 5, in this regard, the Closed Access cities have become outliers—much higher rents leading to much higher prices.

Closed Access cities have become outliers in terms of rent and price because they have also become outliers in terms of new housing construction and income. Figure 6 shows a similar pattern as figure 5. Over the past two decades, these cities have seen their incomes rise well above the national average. Even more surprisingly, as their incomes have risen, the portion of those incomes that goes to rent has *increased*. For typical households in the Closed Access cities, incomes have become much higher than incomes in other cities, but the extra income goes to rent.⁵

The Closed Access cities have become new centers of prosperity, but they have limited the growth in their populations through restrictive zoning and bureaucratic obstacles that make it difficult to build housing. This has turned them into enclaves of privilege, only open to the richest newcomers, who spend nearly half their incomes on rent. This pattern has only developed since the 1990s and is neither normal nor natural.

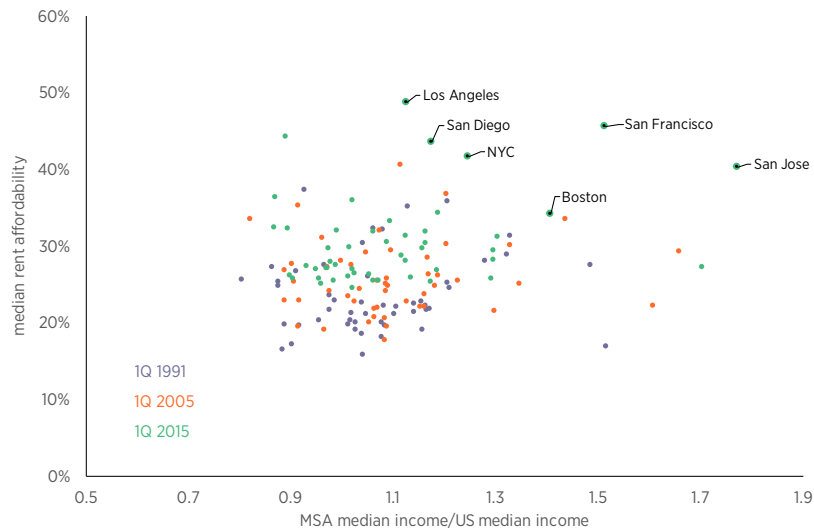
From 1996 to 2005, across the United States permits were issued to build 6.5 homes per 100 residents. The Los Angeles, Boston, and New York metro areas each approved fewer than 2.6 per 100 during that time. San Francisco approved 3.4. In contrast, other economically prosperous cities that attract aspirational families in search of economic opportunity, such as Washington, DC, Seattle, and Dallas, issued permits at rates higher than the national average.⁶

Figure 5. Median Annual Rent and Median Home Price



Source: Zillow Research, “Mortgage Affordability, Rent Affordability, Price-to-Income Ratio,” accessed February 2016, <https://www.zillow.com/research/data/>; Zillow Research, “Median Household Income,” accessed February 2016, <https://www.zillow.com/research/data/>.

Figure 6. Median Rent Affordability and Income



Source: Zillow Research, “Mortgage Affordability, Rent Affordability, Price-to-Income Ratio”; Zillow Research, “Median Household Income.” “Rent affordability” is an estimate of the portion of the median income required to rent the median housing unit. Median Household Income for each metro area is shown as a ratio of the metropolitan area median income to the US median.

THE CLOSED ACCESS MIGRATION EVENT

Contrary to Chairman Bernanke’s assumption, at the national level there was no overhang of housing supply that needed to be worked off in 2011. Indeed, even in 2005 there was no national oversupply of housing. Rather, the American economy was burdened by a shortage of housing, especially in the Closed Access cities.

The housing bubble was concentrated in cities in the coastal Northeast, California, Nevada, Arizona, and Florida. Limiting our analysis to the 20 largest metropolitan areas, the Closed Access cities make up three-quarters of the “bubble” cities, in terms of total real estate valuation. Constrained housing supply was clearly the primary source of high prices in those cities, not excess demand. Prices in the Closed Access cities today remain as high relative to other cities as they were during the bubble because constrained supply is the fundamental reason for those high prices, not reckless credit markets.⁷

Even in other bubble cities with generous building policies, the primary cause of rising prices was the severe Closed Access shortage of housing. This is because those other bubble cities were the main destinations for households migrating out of the Closed Access cities. I call those cities Contagion cities, because in spite of their more generous building policies, they were overwhelmed by the problem created by the Closed Access cities. In the years leading up to the financial crisis, the shortage of housing in the Closed Access cities had become so severe that each year hundreds of thousands of households moved away in search of an affordable home. Many of them landed in inland California, Nevada, Arizona, and Florida.⁸

Figure 7 compares net domestic migration of Closed Access cities and Contagion cities. Notice that high rates of out-migration from Closed Access cities correspond to periods of large in-migration to the Contagion cities. Credit markets may have facilitated some of the housing activity during the housing bubble, but at its core this was a mass migration event caused by a lack of housing.

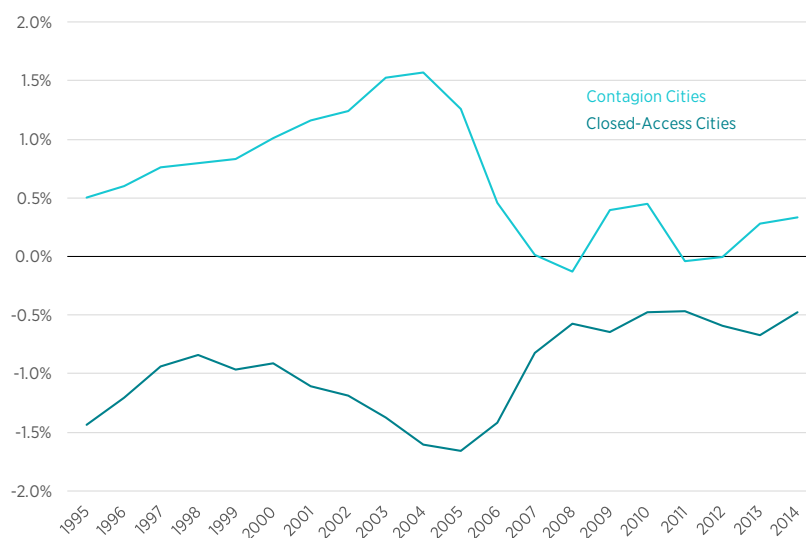
THE MYSTERY IS THE COLLAPSE OF DEMAND

For many people, it seemed obvious that there was overbuilding in places like Phoenix. From 2003 to 2005, Phoenix built many homes. Meanwhile, prices of Phoenix homes rose by about 75 percent in just two years. By 2007, however, the Phoenix housing market was collapsing, buried in a mountain of unclaimed inventory. Surely, it was argued, this was a classic credit-fueled boom and bust.

But, for the boom-and-bust story to add up, Phoenix would have had to build enough homes for all of those new households moving in from California, and then it would also have had to build tens of thousands of units in addition to that. It couldn't. The problem Phoenix encountered was that the in-migration was so strong that even Phoenix authorities couldn't approve new supply fast enough to meet demand.

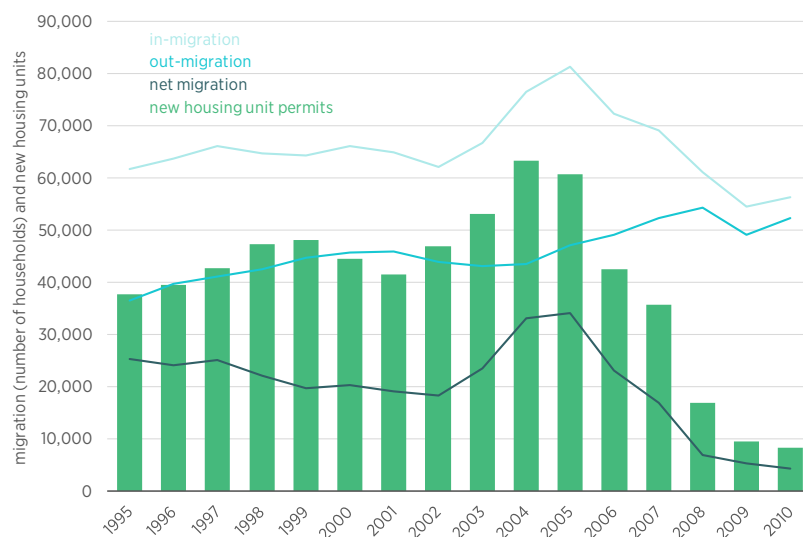
Building permits in Phoenix jumped by about 50 percent from 2001 to 2004. By all appearances, that is an extremely frothy market, but as figure 8 shows, the jump in new homes tracked virtually 1:1 with net in-migration.⁹

Figure 7. Rate of Net Domestic Migration



Source: Internal Revenue Service, "SOI Tax Stats—Migration Data," accessed March 9, 2018, <https://www.irs.gov/statistics/soi-tax-stats-migration-data>.

Figure 8. Phoenix Domestic Migration and New Housing



Source: For counties in the Phoenix MSA, see Internal Revenue Service, “SOI Tax Stats—Migration Data”; for the Phoenix MSA, see US Census Bureau, “Building Permits Survey,” accessed March 9, 2018, <https://www.census.gov/construction/bps/>.

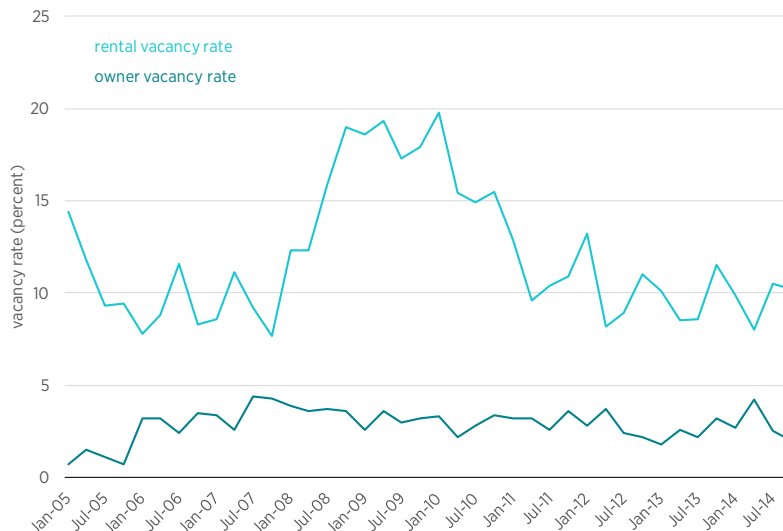
Many of those in-migrants were coming from California. They were moving to Phoenix largely *to reduce their housing expenses*. In fact, even though migration from California had continued to rise up through 2005, net migration into Phoenix had leveled off. That is because increasing numbers of households now began moving away from Phoenix, which had seen soaring home prices. From 2005 to 2008, migration into Phoenix declined each year while migration out of Phoenix continued to rise. By 2008, net in-migration into Phoenix was less than 10,000 households.

By 2006, Phoenix had a growing number of empty homes and a large inventory of homes for sale. But from 2005 to 2008, the number of new homes approved in Phoenix dropped faster than net migration was dropping. Housing supply had reacted remarkably quickly to shifting demand. Even as housing starts were collapsing, rents were rising, as they were in most cities at the time.¹⁰

Furthermore, housing vacancies in Phoenix followed an interesting pattern. As figure 9 shows, vacancies among owned homes rose in 2006, but vacancies among rentals remained stable until 2008. In most other cities, there wasn’t a systematic shift in vacancies. This pattern is mostly limited to the Contagion cities that had been exposed to Closed Access migration events. There were plenty of *tenants* for the housing units that existed in 2006. What those housing markets lacked were *buyers*. There was not an oversupply of homes in Phoenix. There was an undersupply of buyers. By 2008, when rental vacancies rose, the problem was that a decades-long flow of migration had suddenly dissipated to a dribble.

The question that needs to be addressed about the housing bubble and the ensuing bust is not

Figure 9. Phoenix Housing Vacancy Rates



Source: US Census Bureau, "Housing Vacancies and Homeownership (CPS/HVS), Table 4a. Rental Vacancy Rates for the 75 Largest Metropolitan Statistical Areas: 2005 to 2014," accessed March 9, 2018, <https://www.census.gov/housing/hvs/data/rates.html>; US Census Bureau, "Housing Vacancies and Homeownership (CPS/HVS), Table 5a. Homeowner Vacancy Rates for the 75 Largest Metropolitan Statistical Areas: 2005 to 2014," accessed March 9, 2018, <https://www.census.gov/housing/hvs/data/rates.html>.

what caused prices to rise so sharply. That is a fairly straightforward question, with a standard economic answer. Fundamentally, there weren't enough houses.

What caused the massive out-migration from the Closed Access cities? The answer to that question is also, fundamentally, that there weren't enough houses.

This leaves one additional question that has been rarely asked, and which must be answered if we are to come to terms with the crisis that followed. If a lack of housing was fundamentally the cause of the housing bubble, then why had housing starts been collapsing for more than a year before the series of events occurred that we associate with the crisis, like nationally collapsing home prices, defaults, financial panics, and recession? And what caused the Closed Access migration event to suddenly stop at the same time as the collapse of housing starts?

For a decade, the collapse has been treated as if it was inevitable, and the important question seemed to be, What caused the bubble that led to the collapse? This needs to be flipped around. Given the urban housing shortage, it was rising prices that were inevitable. So the important question is, Why did prices and housing starts collapse even though the supply shortage remains? And why were housing starts still at depression levels in 2011?¹¹

The surprising answer to those questions may be that a housing bubble didn't lead to an inevitable recession. It may be that a moral panic developed about building and lending. The policies the

public demanded as a result of that moral panic led to a recession that was largely self-inflicted and unnecessary. They also led to an unnecessary housing depression that continues to this day.

ABOUT THE AUTHOR

After 17 years as a small business owner, Kevin Erdmann returned to school to earn a graduate degree in finance in order to focus on financial research. He began blogging at idiosyncraticwhisk.blogspot.com in 2013. Applying his data-driven analytical approach to a review of the housing bubble and financial crisis led him to a radical shift in thinking about those events. He is finishing two books with the Mercatus Center on this topic and is pursuing avenues for sharing the implications of these findings with policymakers, firms, and investors.

NOTES

1. Ben S. Bernanke, *The Courage to Act: A Memoir of a Crisis and Its Aftermath* (New York: W.W. Norton & Company), 503.
2. US Bureau of Economic Analysis, “National Data, Table 2.3.5. Personal Consumption Expenditures by Major Type of Product,” accessed March 9, 2018, <https://www.bea.gov/iTable/iTable.cfm?reqid=19&step=2#reqid=19&step=2&isuri=1&1921=survey>. Data were retrieved using the “Housing and Utilities” category. Homeowners do not make a cash rent payment to themselves, so nominal rent measures are based on estimates of rental value of owner-occupied homes.
3. Historical inflation data are available by using the Bureau of Labor Statistics data retrieval tools. See Bureau of Labor Statistics, “All Items Less Shelter in U.S. City Average,” accessed March 9, 2018, <https://data.bls.gov/timeseries/CUSR0000SA0L2>; Bureau of Labor Statistics, “Shelter in U.S. City Average,” accessed March 9, 2018, <https://data.bls.gov/timeseries/CUSR0000SAH1>.
4. Two smaller MSAs, San Jose and San Diego, also share the signature of the Closed Access cities.
5. Notice also, in figure 6, that since supply has been constrained nationwide since 2005, rent affordability has become noticeably worse across the country.
6. US Census Bureau, “Building Permits Survey,” accessed March 9, 2018, <https://www.census.gov/construction/bps/>; 1995 population numbers are from US Bureau of Economic Analysis, “Regional Economic Accounts: Download, Table CA1. Personal Income Summary: Personal Income, Population, Per Capita Personal Income,” accessed March 9, 2018, <https://www.bea.gov/regional/downloadzip.cfm>.
7. Zillow Research, dataset sent to author, March 9, 2018. The dataset contained aggregate residential real estate valuations.
8. Net migration from Boston and New York City flows heavily to Florida.
9. Thanks to Michael Kelley for assistance in compiling IRS data.
10. Federal Reserve Bank of St. Louis, “Consumer Price Index for All Urban Customers: Rent of Primary Residence in Phoenix-Mesa-Scottsdale, AZ (CBSA),” accessed March 9, 2018, <https://fred.stlouisfed.org/series/CUUSA429SEHA>; Federal Reserve Bank of St. Louis, “Consumer Price Index for All Urban Consumers: Rent of Primary Residence,” accessed March 9, 2018, <https://fred.stlouisfed.org/series/CUSR0000SEHA>; Federal Reserve Bank of St. Louis, “Consumer Price Index for All Urban Consumers: Owners’ Equivalent Rent of Residences,” accessed March 9, 2018, <https://fred.stlouisfed.org/series/CUSR0000SEHC>; Federal Reserve Bank of St. Louis, “Consumer Price Index for All Urban Consumers: Owners’ Equivalent Rent of Residences in Phoenix-Mesa-Scottsdale, AZ (CBSA),” accessed March 9, 2018, <https://fred.stlouisfed.org/series/CUUSA429SEHC>.
11. Since the countries most similar to the United States—like Canada, Australia, and the United Kingdom—all also have

urban housing supply challenges and have home prices in leading cities that are high as in the United States, and since home prices continued to rise in those countries, it should be clear that it was the collapse that was primarily the result of American federal policies, not the boom.